THE EVOLUTION OF THE ROMANIAN ECONOMY IN THE CONTEXT OF THE INTERNATIONAL CRISIS

Heteş Roxana
West University of Timişoara
Faculty of Economics and Business Administration

Miru Oana
West University of Timişoara
Faculty of Economics and Business Administration

The financial crises that have emerged and developed in the recent decades have been characterized, mostly of an international dimension, with shocks quickly propagating through capital markets, through the international banking activities and, through the money markets. Regarding the impact of the current crisis on the economy of Romania, the contagion effect was transmitted through several channels, but a proper framework in this respect was created by the internal context, mainly the excessive debt. To counteract the increasingly visible effects at the level of macroeconomic indicators, the measures taken by authorities have aimed primarily at the IMF support, being essential, in the following period, to register an improvement of the current situation because, otherwise, this could constitute a real threat towards adopting the euro, putting into question even the quality of Romania's EU membership.

Key words: crisis, recession, causes, policies, remedial measures

JEL codes: G01, G15 , G18, G21,G28, E58

The international crisis context

The initial outbreak of the crisis on the U.S. market has highlighted a number of vulnerabilities of the mortgage market, which’s overlap made the modest initial increase in the volume of loans outstanding to shake the entire U.S. financial sector - the largest in the world - and also to affect the whole world. In a synthetic manner, there can be identified as elements of vulnerability the following:

- the failure caused by placing the titles from tranches with high risk to investors who already had large debts themselves;
- the initiators of mortgages are poorly capitalized financial institutions and are not subject to prudential regulations;
- the lack of transparency of the OTC market, which resulted in the inability of market participants to identify the risk category which the various mortgages carried and the impossibility of quantification of respective risks according to their specifics;
- the OTC markets have also suffered an acute lack of liquidity. As a result, instead of being flexible to price volatility, as it is implied by the concept of "perfect market”, these were closed just when the object of the transactions lost its attractiveness, and buyers began to withdraw.

The crisis has not stopped to the U.S. economy, but also propagated to Europe as well, the first country affected by events in the U.S. being the UK, with problems of Northern Rock, which caused a panic among bank depositors. In an overview, we can say that the current crisis has initially propagated only to developed countries, particularly through the acquisition by European banks of derivative products backed by subprime mortgages, as well as through the increasing market for securities backed by assets. Initially emerging countries have avoided a crisis, maybe due precautions taken following the Asian crisis. But, when the crisis began to affect the real sector, emerging countries have also started to be affected through the trade links with developed economies. Also, through the presence of international financial institutions in these countries, the problems suffered by it in the parent country have passed on to the activities in emerging countries. The same has happened to the nonfinancial multinational companies (Dodd & Mills, 2008).

When the inevitable happened, all those exposed were caught, apparently unprepared. Both in the U.S. and in other countries affected by crisis, central banks have sought various ways to limit the effects of financial crisis and prevent its propagation in the real sector thus causing economic recession. However, not all measures have been successful. Starting with the U.S., central banks have used enormous sums of money to save banks from bankruptcy. In addition to the efforts of each individual central bank, given the systemic nature of the crisis, there can be identified several common lines of action of central banks in the U.S. and EU, respectively: banks' recapitalization, deposit assurance and interbank credit guarantee, takeover by the state from banks of toxic asset, the nationalization of banks and introduction of new regulations.

The EU wants the establishment of a centralized financial supervision; while officials from several countries require the application of more effective and accurate risk management practices. Implementing a more robust set of regulations regarding capital adequacy, strengthening liquidity management practices, improving the standards of risk classification and protection against them and, last but not least, creating a new global financial system, now represent, beyond any doubt, unquestioned needs.

Analyzing the causes, implications and generalized remedial measures promoted by the authorities, the following conclusions could be outlined regarding the current crisis:

- In the attempt of defining it as a real financial crisis or as a pseudo crisis, we may take into account the fact that the recent losses suffered by hedge funds and other players represent pseudo crises. However, the propagation of the crisis on the interbank market and the lack of liquidity for the banking system brought the threat of a real crisis, justifying the FED and ECB interventions. Unlike these, the Bank of England followed a strict Bagehot policy, maintaining its discount operations, but with a penalty rate. Massive withdrawal of funds from Northern Rock on September 14th, 2007 have not reflected the inability of the central bank to act as a lender of last resort, but the perceived problems of public deposit guarantee schemes and the uncoordinated actions from the Financial Stability Authority and the Bank of England.

- By reducing the interest rate between September and December 2007, the FED has acted properly by temporary moving from inflationary problems to recession problems. The relaxation of interest rates is not dangerous as long as the monetary policy is credible. However, once the danger of a recession disappears, the monetary authority should revert to anti inflationary policies and increase interest rates, in order to maintain credibility. The ECB and the Bank of England, although were facing a generalized lack of liquidity in the financial system did not initially reduce interest rates, but injected liquidity into the system through the money market.

- The FED reacted to the boom in asset prices in their bust period. It could have preventively acted to reduce the likelihood of sudden price fall, with adverse consequences on the economy.

- The financial crisis on the U.S. market could have been avoided if the FED would not have provided such high volume of cash in the 2001-2004 periods. It began injecting liquidity into the economy in response to shocks (dot.com crisis, terrorist attacks on 9/11) that could have lead to financial crisis, but when they found that no such crises occurred, the additional funds remained on the money market.

The impact on the Romanian economy

The economic crisis which affects Romania today is mainly an internal crisis, with a main excessive debt as a main cause. The international financial crisis represents only the trigger for the Romanian crisis because it has affected the funding sources.

To understand why Romania faces an overconsumption crisis, a presentation of its premises is necessary. Thus, in the past nine years, Romania has shown economic growth and, in seven of them with annual rates that have exceeded 5%. Even if investments have risen in the recent years, the public and private sectors grew at a higher rate, therefore becoming the main driver for domestic demand. This alert evolution rapidly attracted significant changes mainly in the consumption standards of the population which aimed to be consistent with the evolution of the Romanian society. All these influences have led to a strong emphasis of external deficits.

If, however, we also consider the context in which the Romanian economy has helped consumption increase, it can be observed that the massive capital inputs have led to strong appreciation of the Romanian leu and supported favorable granting conditions for consumer loans for both population and companies. This has not been a concern because the expansion of small and medium sized companies is actually the engine of development of an economy. If you also add to it the bulk of foreign capital entry in the Romanian banking system (and financial system, as a whole) it becomes very clear that the rapid expansion of credit to non-government sector (households and businesses) was inevitable (Tătaru, 2008).

This phenomenon has occurred in the same manner as in all emerging economies in Central and Eastern Europe, as Romania had a real annual non-government credit growth (in lei and foreign currency denominated) of over 30-40%. It can also be observed that it is not the public budget that is liable for, first, the size of the external deficits, as the share of the budget deficit compared to the current account deficit is significantly reduced. The size of the current account deficit is the reason why the rating agencies have put Romania in the group of countries in which investments are very risky.

The current financial crisis has propagated to the Romanian economy through the following channels: trade, financial, trust, exchange rate and through the wealth and balance sheet effects. Through *the trade channel*, export growth slowed down, and even reduced. *The financial channel* has limited the access to external financing and, thus restricted the volume of credit generated, and created difficulties in the private external debt service. In terms of the exchange rate channel, the reduction in external financing was reflected in the national currency depreciation. Because of the *confidence channel*, investors exited from Eastern Europe. Therefore the monetary and exchange markets there were moments of panic and speculative attacks, such as in October 2008, which made necessary the intervention of the NBR. Finally, through the wealth and balance sheet channel the net assets of population and companies have deteriorated, as a result of higher share of credits in foreign currency (related with the depreciation rate) and reduced prices of titles and real estate from speculative, unsustainable values (NBR, 2009).

The analysis of macroeconomic developments in the Romanian economy indicates that the global crisis began to manifest in Romania in the fourth quarter of 2008, but will enlarge this year. Thus, the GDP fell in the first quarter of this year by 6.2% over the same period in 2008. Detailed statistics on the GDP in the first quarter of this year show a contraction of activity in all sectors of the Romanian economy, except the construction sector. Agriculture, forestry and fishery declined in the first quarter with 10.9% compared to the same period last year, industry with 11.1%, the activity of trade, hotels and restaurants, transport and telecommunications have compressed by 7, 6% and financial activities, real estate, renting and business services fell by 3.8%. Constructions and have increased their volume of activity by 4.7%, but face a strong loss of speed (INSSE, 2009). It is expected that the slowdown will worsen in following quarters, so the constructions will see losses (Figure 1).

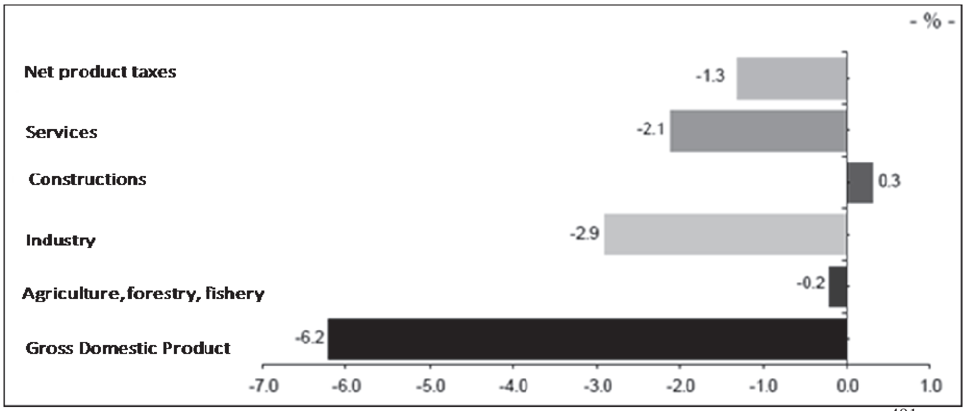

Figure 1 - Contribution of the main branches of activity to GDP (2009)[491]

Regarding *the labor market,* it faces difficulties following the reduction of activity in the last quarter of 2008, especially at the level of registered unemployment. As a result, registered unemployment rate rose to 4.4% in December 2008, compared to 3.9% in September 2008. In the first quarter of 2009, the number of employees has continued to reduce. In April, however, the number of registered unemployed persons rose by just 1%, reaching 517.7 thousand persons (Figure 2).

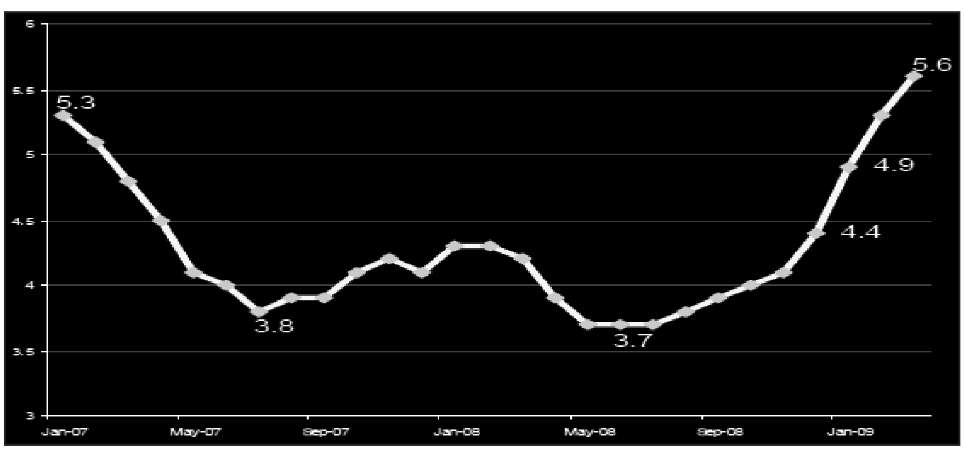

Figure 2 - Evolution of the unemployment rate (2007-2009)[492]

[491] INSSE, Buletin statistic lunar no.5, 2009
[492] National Bank of Romania, Financial Stabity Report 2008

The current account deficit increased by 1.3% in 2008, reaching a level of 16.9 billion e (12.3% of GDP) being financed in a proportion of 58.4% by direct foreign investment, which have totaled a 9.8 billion Euros, compared with 7.3 billion Euros recorded in 2007. In the first quarter of 2009, the current account situation has improved, with its decreasing deficit by 82.1% to the value of 709 million Euros. The current account deficit was fully financed from foreign direct investment, which totaled 1.456 billion Euros compared with 1.691 billion in first quarter of 2008 (INSSE, 2009). According to the forecasts of analysts at Bank of America Securities and Merrill Lynch, the current account deficit of Romania will reach a level of 5% of GDP in 2009, and not at 8%, as it had been previously estimated. For 2010, analysts forecast a current account deficit of 4.1% of GDP, as compared with 6.5%, as had been previously announced.

The *annual inflation rate* reached 6.3% in 2008, exceeding the target of 3.8% plus / minus one percentage point. In the first 3 months of the year 2009, the annual inflation rate reached a level of 6.71%. In the first four months compared with the similar period of previous year, the national currency registered a depreciation of 13.4% in nominal terms against the euro. Analysts Bank of America Securities and Merrill Lynch believe that this year, inflation will also exceed the target set by the NBR, of 3.5% plus / minus 1 percentage point, as they anticipate that inflation could reach 5.2% in 2009, and 4% in 2010 (Figure 3).

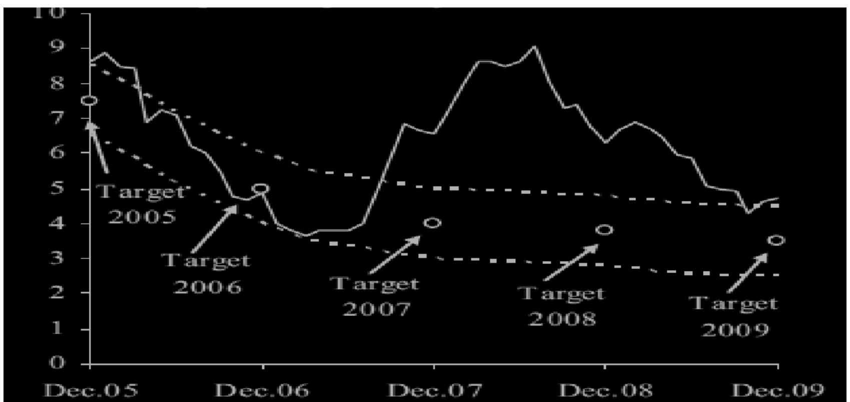

Figure 3- Inflation Developments, annual percentage change[493]

To face the crisis, Romania has completed an agreement with the International Monetary Fund for a loan worth 20 billion Euros. The expected benefits to be derived from this loan are currency appreciation, regaining investors' confidence in the local economy and improving the country rating.

The risks associated with the IMF loan are immense for both those who granted the loan, and for those who receive it. The IMF and the EU should look more determined than ever to force the Romanian authorities to respect the rules, otherwise risking to see Romania turning into a financial black hole. The game is more than the failure to maintain standards of life and help the country return to a favorable rating for investments. The failure to implement a healthy economic plan, associated with a two years loan, could plunge Romania into economic recession, mass unemployment and rising inflation.

---

[493] National Bank of Romania, Inflation Report, february, 2010

Conclusions

Generally, the financial crises that have emerged and developed in the recent decades have been characterized, mostly of an international dimension, with shocks quickly propagating through capital markets, through the international banking activities and, through the money markets. Falling on the same trajectory, the subprime mortgage crisis has not affected only the U.S. economy, but has crossed the ocean, affecting a large part of European countries, showing large contagion effects.

Regarding the impact of the current crisis on the economy of Romania, the contagion effect was transmitted through several channels (commercial, financial, confidence, exchange rate, the wealth and balance sheet effects), but a proper framework in this respect was created by the internal context, mainly the excessive debt. In other words, the economic crisis that Romania is crossing today can be considered mainly a domestic crisis, with the international financial crisis representing only an accelerating momentum in a direction which, however, would have proven inevitable. To counteract the increasingly visible effects at the level of macroeconomic indicators, the measures taken by authorities have aimed primarily the IMF support, being essential, in the following period, to register an improvement of the current situation because, otherwise, it could constitute a real threat towards adopting the euro, putting into question even the quality of Romania's EU membership.

References

1. Bordo, M.D. (2007), *The crisis of 2007: some lessons from history* in The First Global Financial Crisis of the 21st Century , available on - line at http://www.voxeu.org/index.php?q=node/1352
2. Cerna, S. (2008) *Turbulenţele de pe pieţele financiare internaţionale: cauze, consecinţe, remedii*, in Oeconomica, Rosetti Educational Publishing House, Bucureşti
3. Dodd, R., Mills, P. (2008), *Outbreak: U.S. Subprime Contagion*, in Finance and Development- A quarterly magazine of the IMF, available on-line at http://www.imf.org/external/pubs/ft/fandd/2008/06/dodd.htm
4. European Central Bank (2008), *Financial stability Review*, available on-line at http://www.ecb.int/pub/pdf/other/financialstabilityreview200806en.pdf
5. INSSE (2009), *Buletin statistic lunar*, no.5 available at http://www.insse.ro/cms/files%5Carhiva_buletine2009/bsl_5.pdf
6. National Bank of Romania (2008), *Financial Stabity Report*, available at http://www.nbr.ro/PublicationDocuments.aspx?icid=6711
7. National Bank of Romania (2010), *Inflation Report*, february, available at http://www.bnr.ro/Regular-publications-2504.aspx
8. Tătaru,V.(2008) *Cauze şi soluţii pentru criza economică românească* in Vertical, available at http://old.verticalonline.ro/arhiva/index.dex?page=news&arhivanr=154&ziar=154&cat=2416